INDEX

	Page
Petition	1
Opinion Below	1
Jurisdiction	2
Question Presented	2
Statute and Regulations Involved	2
Statement	2
Jurisdiction of the Court Below	3
Reasons for Granting the Writ	3
Conclusion	8

Appendix A	1a
Appendix B	6a

CITATIONS

CASES:

Chock Full O' Nuts Corp. v. *United States*, 453 F.2d 300 (2d Cir. 1971)	8
Hunt Foods & Industries, Inc., 57 T.C. 633 (1971)	8
National Alfalfa Dehydrating and Milling Co., 472 F.2d 796 (10th Cir. 1973)	3, 6, 8

MISCELLANEOUS:

Treasury Regulations on Income Tax (26 C.F.R.): § 1.163-3(b), Example (3)	3

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 217-72

AMF INCORPORATED, *Petitioner*

v.

THE UNITED STATES, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITION

AMF Incorporated, by Eric R. Fox, its attorney, prays that a writ of certiorari be issued to review the judgment of the United States Court of Claims in this case.

OPINION BELOW

The Opinion of the United States Court of Claims in this proceeding is reported at — Ct. Cls. —; — F.2d —; 31 A.F.T.R. 2d 73-1136. A copy of the opinion is set forth in Appendix A hereto.

JURISDICTION

The judgment of the Court of claims was entered on April 13, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

Did AMF Incorporated incur amortizable bond discount in an amount equal to the value of the conversion rights when it sold convertible debentures at par?

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of §§ 163 and 1232 of the Internal Revenue Code of 1954 (as effective in 1961), and of Treasury Regulations on Income Tax (1954 Code) §§ 1.61-12(c)(3) (as effective in 1961), 1.163-3 (effective since 1968), and 1.1232-3 (as effective in 1961 and as effective since 1968) are set forth in Appendix B hereto.

STATEMENT

On or about March 1, 1961, AMF sold at par ($100) $39,911,100 of twenty year, 4¼% convertible debentures due March 1, 1981. The debentures were convertible at the rate of 5/6 of a share of common stock for each $100 debenture through March 1, 1971 (*i.e.*, $120 per common share) and at a somewhat lesser rate ($130 per common share) thereafter until maturity. The conversion rate was subsequently adjusted for the two-for-one stock split of the taxpayer's common stock approved at its annual meeting of stockholders on April 18, 1961. The debentures consisted of two property interests—debt and equity (conversion rights). As of the date of issuance, the value of the debt portion of the debentures was $36,319,101 and the value of the

equity portion of the debentures was $3,591,999. The debt portion of the debentures was issued at a discount of $3,591,999 ($39,911,100 less $36,319,101), property amortizable over the twenty year life of the debentures.

JURISDICTION OF THE COURT BELOW

The jurisdiction of the Court of Claims in this case was based on 28 U.S.C. 1491.

REASONS FOR GRANTING THE WRIT

A conflict exists between the reasoning used by the Court of Claims in this case and the Court of Appeals for the Tenth Circuit in *National Alfalfa Dehydrating and Milling Co.*, 472 F.2d 796 (10th Cir. 1973). Furthermore, there exists a potential direct conflict with respect to the question presented in this case between the Court of Claims and the Court of Appeals for the Second Circuit on the one hand and the Court of Appeals for the Ninth Circuit on the other.

Conflict in Reasoning.

When a bond with a warrant attached to it is issued at a price equal to the par value of the bond, the issuer is entitled to amortize bond discount in an amount equal to the fair market value of the warrant. Regs. § 1.163-3(b), Example (3). In its Brief to the Court of Claims, the petitioner maintained that it was similarly entitled to amortize bond discount when it issued convertible debt because the economic consequences to the issuer were the same as if it had issued bonds with warrants attached. The Court of Claims rejected this argument on the ground that the tax treatment of bonds with warrants attached is not applicable in the

case of convertible debentures because, in the former case, the warrants to buy stock can be separated from the bonds and the two transferred independently of one another whereas, in the latter case, the debt and conversion features of a convertible debenture must travel together as mutually exclusive alternatives.

Perhaps these distinctive features may make some difference to the public since a purchaser of an investment package consisting of a bond with warrants attached can sell the bond and keep the warrants or vice versa while he must retain or transfer both the debt and equity features of a convertible debenture, but they ultimately account for no economic disparity to the issuing corporation.

Assume that a corporation issues a convertible debenture for $100 which gives the purchaser an option to buy five shares of the company's stock at any time during the five year period following issue. If the option is not exercised at the end of that period, the debenture is redeemed for $100. The interest rate is four and one-quarter percent on the convertible debenture and would have been six and one-quarter percent if the debt instrument had been issued without the conversion feature. If the debenture is converted, the issuer keeps the $100 and issues five shares of its stock to the debenture holder. If the debenture is not converted, the issuer pays the debenture holder $100 at the end of five years and there is no change in the number of its outstanding shares. Alternatively, assume that the same corporation issues a $100 par value bond with a warrant attached which entitles the holder to purchase five shares of the issuer's stock for $100 at any time during the five year period following issue. The interest rate on the bond is four and one-quarter percent but

would have been six and one-quarter percent if the warrant had not been attached to it. If the bond is redeemed for $100 and the warrant is not exercised, the issuer is in exactly the same position as if it redeemed its convertible debenture. If the bond is redeemed and the warrant is exercised, the issuing corporation pays the bondholder $100 but receives $100 from the warrant holder and issues five shares of its stock to him. The net result is that the issuer retains $100 and issues five shares of its stock. In this case, the issuer is in exactly the same position as it would be if its convertible debenture were converted.

In both cases, the issuing corporation saved two percentage points of interest on debt instruments by granting options to purchase its stock and was ultimately faced with the same economic consequences regardless of the actions taken by the holders of the two alternative securities it might have issued. Admittedly, there could be some timing differences because in the bond-warrant situation, it would be possible for the warrant to be exercised while the debt remained outstanding and possibly the debt could be repaid while the warrant remained outstanding. This results in no substantive economic distinction, however, since the timing economics are accounted for by the payment or non-payment of interest. Thus, while a bond with a warrant attached may be more appealing to some investors while others find a convertible debenture more desirable, the ultimate economic consequences for the issuer are identical regardless of which investment package it offers. The corporation ultimately either retains the cash originally borrowed and issues additional stock or pays back the borrowed funds and issues no additional stock. In both cases described

above, the corporation saves two percentage points of interest per annum by providing the lender with an option to buy the issuer's stock. The Court of Claims, however, concluded that the issuer of the bond with a warrant attached suffers a loss which it may deduct ratably over the life of the bonds just as if it had to pay two percentage points more of interest during such period whereas the issuer of the convertible debenture suffers no loss. Such a position is economically untenable.

If, as the courts have recognized and the Government concedes by its own Regulations, it is proper to allocate the purchase price of a bond with warrants attached between the debt portion of the investment unit and the option to determine whether bond discount is present, it must logically follow that an identical allocation should be made in the case of a convertible debenture. The Court of Claims, however, refused to recognize the economic equivalence of the alternative forms of issuing debt and stock options.

In the *National Alfalfa* case, *supra,* the taxpayer had issued one $50 par value debenture for each share of its $50 par value preferred stock outstanding at a time when the preferred had a fair market value of $33. The taxpayer had claimed bond discount equal to $17, the difference, it maintained, between what it got and what it gave. The Commissioner had taken the position that no discount arose because the issuing company was exchanging its $50 par value debentures for shares of preferred stock for which it had originally received $50 and was upheld by the Tax Court. The Tenth Circuit rejected this view because it did not take into consideration the economic realities of the exchange and re-

versed the Tax Court's decision. The court explained its position as follows:

> Assume that National Alfalfa sold 200 of its $50 debentures to John Doe at a discount of $17 per debenture and received $6,600 for such debentures; and in the same tax year that it sold such debentures, it purchased from one of its preferred stockholders 200 shares of its $50 par value preferred stock at the market price of $33 per share. Could there be any doubt that National Alfalfa could deduct from its gross income the $17 discount on each of such debentures so sold as interest paid, amortized over the life of the debentures? We think the answer is obviously 'No.' Yet the $17 discount, plus $33, is exactly the same amount National Alfalfa received for such preferred shares when it sold them.
>
> Assume the same facts stated in the above example, except National Alfalfa sold such 200 debentures at a discount of $17 per debenture to one of its preferred stockholders; and from the same stockholder in the same tax year purchased 200 shares of its preferred stock for $33 per share. Would there be any doubt of the right of National Alfalfa to likewise deduct from its gross income such $17 discount as interest paid, amortized over the life of the debentures? Again, we think the answer is obviously 'No,' yet as in the first example the $17 discount, plus $33 per share, is the same amount National Alfalfa received for each share of such preferred stock when it sold it.
>
> In substance, there is no difference between the facts in the instant case and the facts in the second example stated above.
>
> Hence, we hold that the decisions of the Commissioner and the Tax Court in the instant case are based on a nonapplicable premise, viz, that National Alfalfa suffered no loss.

In the *National Alfalfa* case, the court did not refuse to recognize economic equivalence as did the Court of Claims. Petitioner maintains that this difference in analysis represents a clear conflict which should be resolved by this Court. Petitioner would note that the Government apparently agrees with this position inasmuch as it has suggested a conflict between the *AMF* decision and *National Alfalfa* at pp. 10 and 11 of its petition for a writ of certiorari in the latter case.

Potential Direct Conflict.

The judgment of the Court of Claims in this case is virtually identical to judgments rendered by the Court of Appeals for the Second Circuit in *Chock Full O' Nuts Corp.* v. *United States,* 453 F.2d 300 (2d Cir. 1971) and the United States Tax Court in *Hunt Foods & Industries, Inc.,* 57 T.C. 633 (1972). The judgment in the latter case has been appealed to the United States Court of Appeals for the Ninth Circuit and all Briefs in the case have been filed. If the Ninth Circuit reverses the Tax Court, a conflict between the Ninth Circuit on the one hand and the Second Circuit and Court of Claims on the other will be created. Such a direct conflict would be a further strong reason for this Court to grant a writ of certiorari in this case.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be granted.

ERIC R. FOX
Attorney for Petitioner